Mezzanine Financing

Mezzanine financing is a hybrid between debt and equity. In a multi-tiered financing of an operation, for instances, the sources of money will be senior debt, senior subordinated debt, subordinated debt, *mezzanine debt*, and finally the owner's own equity. In other words, the mezzanine lender is very close to being last to get paid if something goes wrong.

Mezzanine financing is a loan to the owner with terms that subordinate the loan both to different levels of senior debt as well as to secured junior debt. But the mezzanine lender typically has a warrant (meaning a legal right fixed in writing) enabling him or her to convert the security into equity at a predetermined price per share if the loan is not paid on time or in full. Many variants exist, of course, the most common being that a portion of the money is paid back *as equity*. Being unsecured and highly subordinated, mezzanine financing is very expensive, with lenders looking for 20 percent returns and up. Unless a market is very flush with money and "irrational exuberance" reigns (to use a phrase coined by the retired chairman of the Federal Reserve, Alan Greenspan), the mezzanine lender will be reluctant to lend unless the company has a high cash flow, a good history of earnings and growth, and stature within its industry. Mezzanine is decidedly *not* a source of start-up funding. Major sources of mezzanine financing include private investors, insurance companies, mutual funds, pension funds, and banks.

MEZZANINE MECHANICS

Financing programs or acquisitions by this mechanism typically involve some combination of lending by the source of money and provision of equity by the borrower. The narrowest case is one in which the lender lends cash and gets a warrant to convert the loan, or portions of it, to stock either any time at the lender's option or in the case of partial or complete default. More usually the following conditions prevail: A sum of money changes hands. Most of it is lent to the borrower at an interest rate but a portion of it is in the form of a favorable sale of equity. In addition there may also be a warrant for the lender and restrictive covenants under which the lender is further protected. The loan will typically fetch an interest rate well above the prime rate and will be for a period of four to eight years.

In the ideal case, the mezzanine financier anticipates earning a high interest on the loan and rapid appreciation of the equity he or she has acquired (or can acquire at a low price with the warrant). Mezzanine financing is typically used in acquisitions based on leveraged buyouts in which all of the investors, not least the mezzanine financier, anticipate cashing out by taking the business public again and refinancing it after the acquisition. Thus the equity can be turned into cash with a substantial gain on the capital. In the event of a failure, the mezzanine lender has little recourse except to influence the company's turnaround by using its stock acquired by means of the warrant.

The borrower turns to mezzanine lenders because he or she cannot acquire capital by other means for lack of collateral or because its finances cannot attract less expensive lending. The price of the money, of course, is high due to high rates of interest, but the owner is betting on being able to repay the loan without yielding too much control.

THE PROS AND CONS

Advantages

1. The owner rarely loses outright control of the company or its direction. Provided the company continues to grow and prosper, its owners are unlikely to encounter any interference from the mezzanine lender.
2. The method offers a lot of flexibility in shaping amortization schedules and the rules of the borrowing itself, not least specifying special conditions for repayment.
3. Lenders willing to enter into the world of mezzanine financing tend to be long-term investors rather than people looking to make a quick killing.
4. Mezzanine lenders can provide valuable strategic assistance.
5. Mezzanine financing increases the value of stock held by existing shareholders although mezzanine equity will dilute the value of the stock.
6. Most importantly, mezzanine financing provides business owners with the capital they need to acquire another business or expand into another production or market area.
7. **Disadvantages**
8. Mezzanine financing may involve loss of control over the business particularly if projections do not work out as envision or if the equity portion of the borrowing is high enough to give the mezzanine lender a larger share.
9. Subordinated debt agreements may include restrictive covenants. Mezzanine lenders frequently insist on restrictive covenants; these may include requirements that the borrower is not to borrow more money, refinance senior debt from traditional loans, or create additional security interests in the company's assets; covenants may also force the borrower to meet certain financial ratios—e.g., cash flow to equity.
10. Similarly, business owners who agree to mezzanine financing may be forced to accept restrictions in how they spend their money in certain areas, such as compensation of important personnel (in such instances, a business owner may not be able to offer above-market packages to current or prospective employees). In some cases, business owners have even been asked to take pay cuts themselves and/or limit dividend payouts.
11. Mezzanine financing is more expensive than traditional or senior debt arrangements.

12. Arranging for mezzanine financing can be an arduous, lengthy process. Most mezzanine deals will take at least three months to arrange, and many will take twice that long to complete.

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